

directly or through a mutual fund is subject to tax. The Internal Revenue Service recently tightened requirements for the very similar so-called wrap-around annuities, but experience suggests that tax can be avoided on virtually any investment by calling it insurance and purchasing it through an insurance company according to certain technical restrictions. Such a tax avoidance opportunity is arguably unfair and inefficient.

Those who favor the exclusion of life insurance interest argue that the interest is not received in cash until the policy matures (though this is also true of some long-term bank deposit certificates, the interest on which is taxed currently). They also contend that the uncertainty of earnings would cause taxation to be a disruptive burden to the entire life insurance industry, and make whole life insurance much less attractive.

RAISE CIVIL SERVICE RETIREMENT CONTRIBUTION RATES
(B-600-h)

Relative to CBO Baseline	Annual Added Receipts (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
<hr/>						
Employee Contributions						
Revenues	0.4	0.9	1.4	1.5	1.6	5.8
Payments from Off-Budget Agencies						
Negative Outlays	<u>0.1</u>	<u>0.2</u>	<u>0.3</u>	<u>0.3</u>	<u>0.3</u>	<u>1.2</u>
Total Addition	0.5	1.1	1.7	1.8	1.9	7.0

Most federal civilian employees and their employing agencies both contribute 7 percent of salary to the Civil Service Retirement (CSR) system in order to help fund future retirement benefits. These contributions, however, do not fund the cost-of-living adjustments (COLAs) received after retirement; instead, COLAs are indirectly funded by federal payments appropriated to CSR. An increase of 2 percent of pay in both the employee and employer contribution rates would fund the relatively better cost-of-living protection afforded federal civilian retirees compared with COLA protection prevailing in the private sector. If the contribution rates were gradually increased to 9 percent, in increments of 0.7 percentage points a year beginning in 1983, additional federal receipts over the five years could reach \$7.0 billion. This estimate includes \$5.8 billion in revenue from increased employee contributions and \$1.2 billion of offsetting receipts (negative outlays) from the higher contributions that would be paid by the U.S. Postal Service and other off-budget agencies.

An increase in the CSR contribution rates would recognize that COLA provisions for federal annuitants are expensive and more generous than private-sector practices. Raising the contribution rates of on-budget employing agencies would have no ultimate budgetary effect, since these agency contributions are internal transactions within the budget. It would, however, improve cost accountability for CSR and, in turn, management decisions about the costs and scope of federal programs.

The budgetary reduction from this proposal would be achieved at the expense of higher postage rates (averaging about 0.8 percent for the five-year period) and lower take-home pay for federal civilian employees. Opponents would argue that mail users should not be asked to pay for post-retirement benefit changes prescribed by the Congress. They would also point out that federal employees already contribute to their pension plans at a higher rate of pay than private-sector employees do toward their anticipated Social Security retirement benefits. (Few private-sector employees shoulder any of the costs of the pensions they will receive from their employing firms.)

TAX ALL UNEMPLOYMENT INSURANCE BENEFITS
(B-600-i)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	1.9	1.7	1.7	1.8	1.8	8.9

Unemployment compensation paid under most government programs is treated as taxable income to individuals with incomes above \$20,000 and couples with incomes above \$25,000. For such taxpayers, half of each dollar of benefit payments is included in adjusted gross income. Most taxpayers receiving benefits are unaffected by the provision, however, because the taxation thresholds are so high.

Taxing all unemployment insurance benefits would increase revenues by nearly \$2 billion in 1983 and by about \$9 billion in 1983-1987.

Taxing all benefits by eliminating the current exclusion would be consistent with a policy of ending artificial tax distinctions between similar sources of income. Privately paid unemployment benefits have always been regarded as fully taxable since they are intended to replace lost taxable earnings. Government-sponsored payments, under this proposal, would be treated similarly. Tax payments would be based on the household's ability to pay, which the tax code already takes into account through exemptions, deductions, and graduated tax rates. As a consequence, even if benefits were taxed in full, most recipients with incomes below about \$10,000 would pay little or no additional tax.

However, since existing benefit levels may be based on their nontaxability, even small tax increases might necessitate a rise in benefit levels to ensure that all taxpayers maintained a minimum living standard.

Taxing benefits would also provide an additional incentive for persons collecting benefits to seek employment. In particular, it would lessen the incentive for temporary layoffs. At present, as much as half of all unemployment can be traced to job losses

involving only temporary layoffs where employers rehire former workers whose layoffs have been cushioned by unemployment benefits. Both employers and employees have an incentive to engage in this practice. Because the unemployment compensation taxes paid by employers with high turnover rates do not fully cover the extra costs they impose on the system, these employers are in effect subsidized by employers with more stable payrolls. At the same time, benefit payments to low- and middle-income workers while on layoff frequently approach after-tax income levels from working, making it easier for them to wait to be rehired rather than look for another job.

TAX FEDERAL EMPLOYEES FOR MEDICARE
(B-600-j)

Addition to CBO Baseline	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Social Security Trust Fund Income	1.3	1.7	1.9	2.2	2.5	9.6
Federal Revenues <u>a/</u>	0.7	1.1	1.2	1.3	1.4	5.7

- a. Represents net increases in total federal revenues after accounting for internal budget transfers from federal agency contributions.

Medicare hospital insurance, which covers most of the nation's aged and disabled, is funded by a portion of Social Security payroll taxes that apply throughout the careers of most active employees. In calendar year 1982, payroll taxes for Medicare will require employees and employers each to pay 1.3 percent of the first \$32,400 of earnings. Although most federal workers do not contribute to Medicare during government service, they may become eligible for Medicare benefits at age 65 if covered by Social Security or if their spouses are covered. Eventually such eligibility will require that individuals reaching age 65 have at least ten years of covered employment; at present the eligibility requirement is less stringent.

Federal retirees as well as employees may participate in a separate health care program, the Federal Employees Health Benefits (FEHB) system. For federal workers who also qualify for Medicare hospital insurance, through employment covered by Social Security, FEHB becomes a secondary source of protection, as with other health care plans in the private sector.

The National Commission on Social Security recommended in 1981 that Medicare hospital insurance be extended to federal, state, and local government employees. Making such coverage universal would reduce the subsidy many government workers enjoy because they receive full Medicare benefits but pay little into the program.

Under current law, 80 percent of the retired federal workers aged 65 or older are already covered by Medicare.

Extending coverage to federal employees would generate substantial tax revenues for the federal government and help bolster the Medicare hospital insurance fund. Under this proposal, all federal workers and new retirees would count their federal employment toward satisfying eligibility requirements for Medicare hospital insurance and they could still elect to receive FEHB benefits as a supplement. The additional Social Security taxes paid by all federal employees and employing agencies would add, between 1983 and 1987, some \$9.6 billion to the hospital insurance trust fund. This additional income includes \$3.9 billion of internal transfers from contributions paid by on-budget agencies and \$5.7 billion in federal revenue from employee withholdings and contributions paid by the U.S. Postal Service and other off-budget agencies. (The estimates assume a January 1983 effective date and reflect scheduled increases in Medicare hospital insurance tax rates and the maximum earnings subject to taxation.) The increase in federal revenues would be even greater if all government employees--federal and nonfederal alike--were subject to Medicare hospital insurance taxation.

Distributing the cost of Medicare benefits among all active workers, government as well as private, has been supported as good public policy by many Social Security analysts. But limitations on annual federal pay increases since 1977, as well as dramatic increases in the 1982 FEHB premiums, have already affected the take-home pay of federal workers. Further pay check reductions could hamper the ability of the Department of Defense, which is expanding its work force, to attract and retain qualified employees. Spokesmen for federal employees and their unions argue that the timing for such an extension is wrong regardless of its merits. At a minimum, they hold that any health insurance taxation should also extend Medicare hospital insurance to existing as well as new federal retirees. Such extensions, however, would mean some increase in Medicare outlays but a dampening of future FEHB cost increases.

TAX VETERANS' DISABILITY COMPENSATION
(B-700-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	1.7	1.9	2.2	2.5	9.1

Veterans with service-related disabilities are eligible for monthly cash benefits under the veterans' disability compensation program. Benefits are paid according to the degree of disability and now range from \$58 a month for 10 percent disability to \$1,130 a month for complete disability, with additional payments up to \$3,223 a month for eligible veterans judged to have suffered certain specific severe disabilities. Benefits are tax free and paid without regard to income from other sources. If disability compensation was made taxable, the revenue gain would be \$0.8 billion in 1983 and \$9.1 billion in 1983-1987.

Because payments are available for very minor disabilities, and because they are not reduced for veterans able to work, disability compensation benefits are not closely targeted to financial need. About 39 percent of all beneficiaries are only 10 percent disabled. Because a 10 percent disability can be a relatively minor medical problem, such as a scar or a small reduction of movement in a joint, earning power is oftentimes unimpaired. While those who suffered disabilities in the service of their country are surely entitled to some compensation, benefits for minor disabilities may have a lower priority in times of budgetary stringency.

Any hardships resulting from taxation of benefits could be alleviated by increasing benefits 10 percent for beneficiaries who are at least 50 percent disabled, since they receive the largest benefits and are most likely to be in need. Such an increase would make up for the tax liabilities in the worst case (a beneficiary living alone and unable to work), but would reduce the net budgetary gain by only about one-third.

Opponents of these policy changes would argue that disability compensation for those who suffered long-term physical harm in the

military should not be reduced because of other income, especially if the other income is from the labor of a spouse or from property. As against this, some Members of Congress believe that benefits have been insufficiently targeted on need, and have tried without success to cut back on benefits directly. Taxing benefits has the advantage of targeting the reductions of net income on those least in need without reducing benefits directly.

ELIMINATE DEDUCTIBILITY OF STATE AND LOCAL SALES TAXES
(B-850-a)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.8	5.3	6.0	6.8	7.8	26.7

State and local sales taxes paid may be claimed as an itemized deduction. Eliminating the sales tax deduction would increase federal income tax revenues by \$0.8 billion in 1983 and by \$26.7 billion in 1983-1987. Should some states choose to shift their tax collections from sales to other taxes to preserve deductibility for their residents, the revenue gain would be reduced.

Sales taxes reduce the taxpayer's net income, and thus his ability to pay federal taxes. Normally, however, only expenses that are relatively large and that vary substantially from one taxpayer to another are deductible on ability-to-pay grounds; small, uniform, and predictable expenses are ignored and implicitly taken into account when the zero bracket amount, personal exemptions, and general tax rates are established. The sales tax is such a small, uniform, and predictable expense. Sales taxes are collected in 45 of the 50 states; in 1977, the latest year for which detailed data are available, 96.9 percent of all itemizers claimed the deduction, in amounts varying only from 2.0 percent of adjusted gross income for taxpayers with \$10,000 to \$12,000 of income, to 0.2 percent for those with over \$1 million in income. The sales tax deduction is usually a small item (less than half as large as real estate taxes and about a third of income taxes on average in 1977). Sales tax liabilities do not vary substantially from state to state.

Any ability-to-pay rationale for the sales tax deduction is further undermined by the way it is usually calculated. The deduction amounts in most cases come from printed tables based on the state and the size and income of the family, and presented in the Form 1040 instructions. The deduction is thus usually not based on actual tax payments, and does not compensate for variations in the burden among taxpayers. Further, taxpayers can only justify a

deduction of actual liabilities greater than the IRS table value by documenting each of the hundreds of retail transactions they made during the year. (Alternatively, if a household made a major purchase such as an auto, it can claim the deduction from the IRS table plus a further deduction for the sales tax on the major item. Because the major purchase would likely displace some other consumption, this method probably overcorrects for ability to pay.) Thus, the sales tax deduction may be both the most imprecise and the most burdensome (in terms of recordkeeping) of all the itemized deductions.

Beyond the considerable revenue loss, the imprecision, and the complexity of the deduction, it also has unfortunate incentive effects for both taxpayers and state and local governments. For taxpayers, it marginally and indirectly reduces the cost of consumption at a time when many observers believe the nation would be better served by more saving. For state and local governments, the deduction cushions the burden of the sales tax on taxpayers; but the sales tax, because it adds to price levels, contributes to inflation at the retail level. If the states and localities shifted toward taxes that do not increase prices, this would temporarily decrease the rate of inflation directly, and indirectly reduce business costs through cost-of-living escalators in labor contracts. (Direct reductions of sales taxes would, of course, make consumption even more attractive.)

Advocates of the sales tax deduction argue that the federal government should not influence the states' choice of taxes through selective deductibility. Another argument is that use of the sales tax, popularly held to be a fair tax, should not be discouraged.

LIMIT TAX CREDIT FOR POSSESSIONS CORPORATIONS
(B-850-b)

	Annual Added Revenues (billions of dollars)					Cumulative Five-Year Addition
	1983	1984	1985	1986	1987	
Addition to CBO Baseline	0.2	0.4	0.5	0.5	0.6	2.2

"Possessions corporations" are companies incorporated in the United States that are exempt from U.S. income tax on their operations in Puerto Rico, American Samoa, and Guam. Ninety-nine percent of the revenue loss is attributable to Puerto Rico.

The revenue loss from this exemption--currently estimated to be \$1.3 billion in 1983 and \$1.8 billion in 1987--could be cut by about one-third, without significantly limiting the job-creation effects of the provision, by eliminating the incentive for U.S. companies to transfer their high-profit patents and other intangible assets to Puerto Rico in order to shelter the profits from tax. Such a change would increase revenues by \$200 million in 1983, and by \$2.2 billion in 1983-1987.

The exemption was originally enacted in 1921, mainly to provide U.S. firms doing business in the Philippines, then a U.S. possession, with the same favorable tax treatment enjoyed by their British competitors. In 1975, the House Ways and Means Committee considered repeal of the exemption on the ground that its original purpose was no longer being served, since the Philippines had ceased being a U.S. possession in 1946. Proponents of the exemption argued, however, that it had become crucial to the economic development of another U.S. possession, Puerto Rico. A large number of U.S. firms had established plants in Puerto Rico after Puerto Rico enacted special tax exemption provisions of its own in 1948, and it was argued that these firms were a primary source of jobs in Puerto Rico. It was also argued that the loss of revenue from the provision was quite modest--about \$200-300 million a year--and that this was a small price to pay for the benefits achieved. The Tax Reform Act of 1976 narrowed the possessions corporation exemption somewhat, and required that the Treasury Department report annually on the "operation and effect" of the exemption.

The most recent of these annual reports, released in June 1980, showed that the revenue loss from the exemption was much larger than originally estimated. A loss of \$1.1 billion was expected in 1982, increasing to \$1.5 billion in 1985. Almost 50 percent of the revenue loss in 1978 was attributable to the Puerto Rican operations of 16 large U.S. pharmaceutical companies, according to the Treasury report. Relative to their profits, pharmaceutical possessions corporations employed few people; the annual revenue loss per pharmaceutical company employee in 1978 was an estimated \$43,261, while average compensation in Puerto Rico per pharmaceutical company employee was estimated at \$13,618. For all 390 manufacturing companies benefiting from the exemption, the federal revenue loss per employee in 1978 was estimated to be \$12,667, compared with average employee compensation of \$10,697. The Treasury reports suggest that a major effect of the exemption in the 1970s has been to induce U.S. firms to shift high-profit, low-labor activities to Puerto Rico, with relatively few benefits to the Puerto Rican economy.

Defenders of the exemption argue that it is crucial to long-term Puerto Rican economic growth, that the job loss and economic dislocation that would result from repeal would impose additional costs on the U.S. and Puerto Rican governments, that 1981 federal budget cuts have already put an inordinate burden on Puerto Rico, and that the exemption is an important underpinning of the U.S.-Puerto Rican political relationship. A further consideration in evaluating the tax credit is that the large general business tax cuts enacted in 1981 have eroded to some extent Puerto Rico's comparative tax advantage for U.S. companies.

The efficiency of the possessions corporation tax credit could be increased if it were limited to investments that created substantial numbers of new jobs. As the Treasury reports have indicated, the revenue loss per employee for pharmaceutical companies is more than four times larger than the average for all other manufacturing industries. This is largely because the pharmaceutical companies have transferred many of their high-profit drug patents to their subsidiaries in Puerto Rico, and have then used the possessions tax credit to shelter the profits on the patents from U.S. tax. This tax avoidance practice could be reduced or eliminated by requiring that a U.S. corporation transferring patents, trademarks, and other intangible assets to a possessions corporation include in its taxable U.S. income the full "arm's length" price of the intangible assets. This requirement could be applied to intangible assets previously transferred to Puerto Rico, leaving it to the companies involved to decide whether to continue the current division of assets under the new terms.

APPENDIX C. ASSUMPTIONS USED IN NATIONAL DEFENSE PROJECTIONS--
QUANTITIES OF WEAPONS PROCURED UNDER CBO BASELINE,
POSSIBLE ADMINISTRATION PROGRAM, AND ALTERNATIVE

TABLE C-1. QUANTITIES PROCURED UNDER "LEAPFROG THE B-1 BOMBER AND PROCEED DIRECTLY TO AN ADVANCED TECHNOLOGY BOMBER WHILE INCREASING B-52 ALERT RATES"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
B-1	7	9	36	46	46 <u>a/</u>	N/A
Possible Administration						
B-1	7	9	36	46	46 <u>a/</u>	N/A
Alternative						
B-1	0	0	0	0	46 <u>a/</u>	N/A
Accelerate ATB development						
Increase B-52 alert rates from 30 to 40 percent						

- a. While B-1 purchases in 1987 are not likely, they are included to provide funds for procurement of the ATB. ATB procurement cannot be identified in a public document.

TABLE C-2. QUANTITIES PROCURED UNDER "MODIFY THE TANKER RE-ENGINEING PROGRAM"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
CFM-56	25	58	64	72	72	N/A
Possible Administration <u>a/</u>						
CFM-56	25	58	64	72	72	N/A
Alternative						
JT3D <u>b/</u>	16	48	32	32	32	32

- a. Lacking publicly available information, CBO assumed the possible Administration program matched the baseline program.
- b. JT3D option based on earlier program proposed by the Air Force for 96 aircraft. The extension beyond 96 assumes availability of aircraft for purchase after FAA regulations prohibit operation of these aircraft in U.S. air space.

TABLE C-3. QUANTITIES PROCURED UNDER "MODIFY AND
EXPAND NAVY BATTLE GROUP STRUCTURE"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
CVN	0	1	0	0	0	N/A
Possible Administration <u>a/</u>						
CVN	2	0	0	0	0	1
Alternative						
CVN	0	0	0	0	0	0
Escorts/Airwings			<u>b/</u>			

a. Based on press reports of likely Administration actions.

b. Estimates of long-run costs under this option (which are presented in the text) assume that fewer escorts and airwings will be procured because there are three fewer aircraft carriers that require escorts. Specifically, estimates assume reductions in procurement of five CG-47s, seven DDGXs, and three airwings.

TABLE C-4. QUANTITIES PROCURED UNDER "RESTRUCTURE THE
MODERNIZATION OF NAVAL AIR DEFENSES"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
CG-47	2	4	4	4	4	N/A
Possible Administration <u>a/</u>						
CG-47	3	3	3	4	4	4 <u>b/</u>
Alternative						
CG-47	2	2	2	2	2	4
TER	0	0	0	0	0	81
SM-2	0	0	0	0	0	4,300
Backfit Kits	0	0	0	0	0	81

a. Based on press report in Shipyards Weekly, Shipbuilders Council of America, December 24, 1981.

b. Assumes fulfillment of current Navy objectives.

TABLE C-5. QUANTITIES PROCURED UNDER "PROCURE CONVENTIONAL SUBMARINES TO COMPLEMENT NUCLEAR ATTACK SUBMARINES"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
SSN-688	3	3	3	3	3	N/A
Possible Administration <u>a/</u>						
SSN-688	2	4	3	4	4	5
Alternative						
SSN-688	1	3	2	3	3	0
SSX	0	1	0	2	3	14

a. Based on press report in Shipyard Weekly, Shipbuilders Council of America, December 24, 1981.

TABLE C-6. QUANTITIES PROCURED UNDER "LIMIT M1 TANK PROCUREMENT AND SUPPLEMENT IT WITH M60s"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
M1	802	1,080	1,080	1,080	1,080	N/A
M60A1 upgrade	360	360	360	360	360	
Possible Administration <u>a/</u>						
M1	802	1,080	1,080	1,080	1,080	N/A
M60A1 upgrade	360	360	360	360	360	
Alternative						
M1	720	720	720	720	720	N/A
New M60A3	360	360	360	360	360	N/A
M60A1 upgrade	360	360	360	360	360	

a. Lacking publicly available information, CBO assumed the possible Administration program matched the baseline program.

TABLE C-7. QUANTITIES PROCURED UNDER "ALTER THE COMPOSITION OF THE INFANTRY FIGHTING VEHICLE PROGRAM"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
M2	711	792	986	1,100	1,044	N/A
Possible Administration <u>a/</u>						
M2	711	792	986	1,100	1,044	N/A
Alternative						
M2	360	360	600	600	600	N/A
M113 w/TOW	480	480	480	480	480	N/A
M113 w/Cannon	480	480	480	480	480	N/A

- a. Lacking publicly available information, CBO assumed the possible Administration program matches the baseline program.
- b. Based on informal contractor estimates, CBO assumed that each M113 equipped with TOW or 25-millimeter cannon costs \$421,000 in constant 1983 dollars.

TABLE C-8. QUANTITIES PROCURED UNDER "REVISE THE NAVY AIRCRAFT MODERNIZATION PROGRAM"

	Fiscal Year					To Complete
	1983	1984	1985	1986	1987	
CBO Baseline						
F-14	27	30	30	30	30	N/A
F/A-18	66	96	108	132	132	N/A
A-7X	0	0	0	0	0	N/A
Possible Administration <u>a/</u>						
F-14	27	30	30	30	30	82 <u>b/</u>
F/A-18	66	96	108	132	132	675 <u>c/</u>
A-7X	0	0	0	0	0	0
Alternative						
F-14	6 <u>d/</u>	0	0	0	0	0
F/A-18	66	96	108	108	108	126 <u>e/</u>
A-7X	0	0	0	25	58	782 <u>f/</u>

- a. Lacking publicly available information, CBO assumed the possible Administration program matched the baseline program.
- b. Assumes buy sufficient to fill out 26 squadrons and meet needs for pipeline and advanced attrition.
- c. Based on total buy of 1,366.
- d. Based on completing buy proposed by last Administration.
- e. Based on buy of 1,366 less those for fight attack squadrons.
- f. Based on buy of light attack aircraft. A-7X costs are from informal contractor estimates prepared in mid-1981.